Don't Eat the Chickens®
Thoughts on Family Capital Preservation through Philanthropy

By Paul L. Comstock

"Riches either serve or govern the possessor." Horace

Capital, the source of production, is a precious asset. Individual ownership of capital put to use in a free market economy produces great personal wealth and general economic prosperity. The challenge in any functional free market society is to enable all those who desire it, to have the ability to acquire capital. Once acquired, the challenge to owners of capital is how to maintain it for the benefit of their heirs, in particular their family.

Charitable, religious and educational organizations become both a proxy for individual ownership of capital and a promoter of its formation. Promoting the formation of private capital by philanthropic organizations begins early. The first capital most individuals begin to acquire is that of education capital. The cornerstone of the United States prosperity has been the widespread availability of this basic source of capital formation.

The higher education system in the United States is the envy of the world, and has allowed unprecedented development of competitive personal capital. Although the investment required to obtain this education capital is relatively high, it has been dramatically reduced by voluntary gifts. This is not only true for private education institutions, but also those that receive government sponsorship or support.

In addition, the many private nonprofit organizations within our communities add to individual capital through leadership, moral and social skill training. These faith-based, social service and crisis intervention groups are funded through voluntary support. Individuals, complete with education, leadership, moral and social skills capital, go on to accumulate investment capital. This has often been the start of a new business. These businesses become the source of much of the nation's wealth.

Today, we often forget the value of capital, and what it means to those who have it and those who do not. Private capital is frequently viewed only as the means to a high standard of living. Capital is thought to provide all one needs for the good life. There is no better example of this than that found in the opinion of those in a line to purchase the weekly lottery ticket: "If I could just win the lottery, things would be fine." The good life is generally thought of in terms of the consumption we experience. Unfortunately, many who pursue the good life become awash in self-indulgent behavior and quickly find themselves faced with boredom and low self-esteem. This is particularly true for those for whom the financial source of that pursuit is an inheritance or gifts. In essence, their life centers on fulfilling personal appetites by eating all the chickens (capital) and the eggs (income or gains generated from the capital).

Most observers of the impact of inherited capital on recipients understand that the unwise use of it can be harmful to the recipients` personal development. On the other hand, properly used capital can assist in providing the venue for self-expression and productivity that creates a sense of personal fulfillment and purpose. Capital may also provide individuals with a way to participate in community leadership or to promote their value system. There are many examples of the positive uses of private capital for the public good that bring great joy and satisfaction to its owners.

Andrew Carnegie believed that capital placed in the hands of individuals by virtue of an inheritance had the potential to destroy democracy. To guard against such an occurrence, Carnegie persuaded Congress to tax the transfer of capital between individuals. The basic premise of this tax, the redistribution of capital, is still in place. Only the amounts exempt from the tax and the tax rate have changed. Regardless of the specifics of the transfer tax at any given time, it has played a significant role in determining how capital is passed on to the next generation and how much ultimately stays within the family.

It has been expressed that a family will go "from shirtsleeves to shirtsleeves in three generations." This expression suggests that "one generation makes it, the next uses it, and the third loses it." While these expressions are somewhat accurate, it is not always because of irresponsibility.

In addition to the dilution by taxation is the dilution that occurs by simply dividing the pool of capital by the number of heirs in each generation. An interesting exercise to determine the dilution that will occur is to write down the total value of an individual’s capital. Next, divide the value by the number of next generation heirs. Continue down the paper and divide the value to each heir by the number of his or her heirs. As can be seen, even without government taxation, the amount of capital that each heir receives will be significantly diminished from its current value. That is fine. Most parents and grandparents want their posterity to exhibit character, mental strength, integrity, a sense of family legacy and responsible behavior attributes that "money cannot buy." Or can it? Value promoting activities sponsored by many nonprofit organizations within a community need funding for their programs. This funding, with capital and/or the fruits of it, provides the rising generations with opportunities to develop these non-financial attributes.

Those who have personally achieved financial independence from their own efforts count more than wealth as their reward. Donors, whose sole source of wealth is from a gift source, however, often only have that wealth. They miss the opportunity of the intangible benefits derived from its creation. The experience of creating capital generally develops personal growth, a sense of achievement and self worth. This lack of intangible benefits derived from creating wealth can be dangerous to the recipients of an inheritance. While most owners of capital wish to benefit their posterity with an economic competitive edge, the question becomes, "How much?" Warren Buffet summed up a prevalent current feeling when he said, "The perfect amount to leave children is enough so they would feel they could do anything, but not so much that they could do nothing."

It is for this reason that owners of capital need to be careful in structuring its distribution. They need to be certain that it does not hamper the fulfillment of the non-financial objectives they have for their heirs. The questions requiring consideration when establishing various capital transfer strategies are very simple:

1) What is my capital transfer plan designed to accomplish?

2) Does my capital transfer plan support the non-financial goals my heirs?

3) What is the best structure to provide my heirs with a financial advantage?

4) Are my heirs prepared to be responsible with the capital I leave them?

5) Will my planning bring my family members closer together or pull them apart?

Many individuals approach their capital transfer planning with the attitude of, "I'll let them worry about it." This is particularly true in situations where liquidity to pay the tax is in short supply and current cash flow prohibits the purchase of liquidity through a life insurance policy. Negligence in planning can create feelings of frustration, anger and guilt in unsuspecting heirs. Some owners of capital may even feel a sense of loyalty to their country and believe the tax justified and worthy of paying.

Several years ago, there was an article in USA Today about an individual who had immigrated to the United States and amassed capital worth approximately $6,000,000 at the time of his death. He never married and had no heirs. Because of his gratitude for the opportunities afforded him, his will left his entire estate to the Federal government. The paper went on to ask the following question of those reading the article, "How long did it take the government to spend the amount left to it: two minutes, two hours, or two days?" The answer: two minutes.

Taxes play a vital role in society. They provide the source for government spending. In turn, this spending provides many with employment and has great impact on us all. However, spending in the areas that promote the development of personal capital has been diminishing over the past 15 or more years resulting in both the Federal and state governments requiring more and more of this activity from the private sector.

Many owners of capital feel that it is a tragedy to have worked and sacrificed for a lifetime, only to have their valuable capital (taken under the tax system) leave their influence and control especially when that capital is being consumed rather than maintained. An alternative to reducing family capital through the mandatory transfer tax is to give the taxable portion of one's capital to one or more qualifying charitable organizations. Doing so allows capital to transfer free of any taxation. However, to benefit from this tax provision, the owner of the capital and future heirs must give up more capital for social purposes than under the imposition of the transfer tax.

Why is this so? In making a transfer to a qualifying nonprofit organization, 100% of the value of the capital escapes the heirs. The maximum estate and gift tax bracket is 55%. Giving one's capital to a charitable organization deprives the heirs of 45% of that capital.

Giving capital to personally selected charitable organizations, however, can provide intangible benefits to both the owners of the capital and their heirs, not generally achievable through the tax system. There is the personal satisfaction of seeing the use of family capital in the support of their value system and the public recognition for doing so. The entire family can experience a sense of permanent legacy. Both the owners of the capital and their heirs obtain a slice `of immortality.

To reduce the impact of taxes on transfer planning for the heirs, donors can make tax-free gifts during their lives or create additional capital through the purchase of a life insurance policy. This latter strategy is referred to as wealth replacement. With life insurance trusts that avoid taxation on the death benefits in one or more generations, family capital is replaced for posterity in both a creditor protected and investment efficient format. Making current gifts or creating a wealth replacement strategy through life insurance, however, can cause serious disappointment in the actual outcome without properly preparing those who are to benefit.

It is necessary that each current guardian of the family capital consider a systematic approach to the preparation of the rising generation in their ability, both emotionally and intellectually, to care for the "chickens" left to them. This is a task requiring skillful financial parenting techniques within the family system. It is not a task that should be left to others.

The question then is, "What is the best venue for achieving the goals of a successful financial parenting program?" The answer lies within the family's philanthropic activities. All the instructional opportunities for the responsible and effective management of inherited wealth can come from the family experience of giving to others. This very benefit of family philanthropy may far exceed the tax and recognition benefits of any one giver. It transcends financial reward and culminates in healthy attitudes toward the ownership and use of capital.

The desire to select the social values to support, versus paying a tax to do the same without input, has become a very attractive alternative for owners of capital. Coupled with a wealth replacement strategy, such transfers can provide the next generation with two pools of capital social capital with designated charities and consumption and business capital.

While this concept seems to draw a logical conclusion for most individuals faced with the problem, there is an issue within this structure that can be disturbing. It is important to keep in mind that annual gifts to heirs as well as charitable organizations are usually made from excess income. When the decision is made to give capital this new disturbing issue raises its head. The issue is the passing of control to someone else.

Gifts of capital to charitable organizations are often first suggested by development officers. The use of a testamentary provision in either a will or intervivos trust is the most common form of a capital transfer and postpones loss of control until death. To reduce the concern of giving capital away while the donor is alive, often a split interest gift is suggested. Gift formats, such as charitable remainder trusts and pooled income fund transfers, offer a plan to give the capital now but allow the donor to continue to enjoy the fruits of its production.

Regardless of the logic and desire to benefit society, many owners of capital want to maintain increased control over that activity both now and in the future. It is for this reason that there has been a strong interest in using a family controlled, or influenced, charity format for the recipient of a donor's social capital transfer.

A family controlled or influenced charity as the recipient tax-exempt organization in a capital transfer strategy adds an additional dimension to the process. Such an entity allows the family capital designated for the public good to be maintained in a manner that continues family influence over the causes it supports. In essence, the wealth owner transfers his/her chickens from one coop to another on the same property. The difference in the two coops is that the family may never eat any of the chickens or the eggs from the one designated for the public good. They may, however, maintain various degrees of involvement in the management of the chickens (the capital) and the distribution of the eggs (income). This maintenance of various degrees of responsibility for, and control over, their former family capital also offers future generations opportunities for personal growth, community service and wealth management education that exceeds most family expectations.

The government has determined that the charitable gift and estate tax deduction applies to gifts to all qualifying charitable organizations. Such gifts can be to either a public or private qualifying charity. In determining the charitable organization that will meet the objectives of the current owners of capital, several questions will need to be answered. Who will control the capital after the transfer is complete? Should family members control it or should public boards? Is there a blend of the two options? How much capital will it take to fund this planning option? What type of capital will be given? Are there special management requirements for the contributed capital? What is the financial cost of maintaining control? The answers to these questions will help determine the entity that is best suited to receive the contributed capital.

There are several charity formats that can be considered before choosing which one is best for receiving the donated family capital. It is also possible that there will be a benefit to selecting more than one such format to participate in the capital transfer strategy. Each exempt organization format has various restrictions (level of continued involvement and control) as well as tax considerations. A review of these unique qualities should be made with the assistance of competent legal and tax counsel prior reaching a conclusion and actually facilitating the transfer.

Public Charity

Making a gift of capital to a publicly supported and controlled nonprofit organization may be done on an unrestricted or restricted basis. Restrictions are generally program specific. Public nonprofit organizations often offer the opportunity for continued involvement in program distributions from the previously given capital. Such involvement may include the opportunity to select from a list of funding requests within the restricted use area. This involvement in specific program funding allows for inclusion of the entire family unit. Rising generations then become both connected with the endowed institution as well as the process of program selection.

Private Foundation

In 1969, Congress addressed the guidelines for establishing a privately controlled charity. These organizations are normally established for the express purpose of receiving contributions and distributing grants to public charities. Such an entity is referred to as a private foundation.

In order to curb previous abuses by those who had established such entities with more of a personal benefit in mind, Congress imposed a series of restrictions on those that managed or were the major contributor to a private foundation. The restrictions are found in Sections 4940-4948 of the Internal Revenue Code. While such rules and compliance penalties may initially appear quite daunting, the establishment of procedures to follow by knowledgeable legal counsel coupled with their periodic review of the foundation management practices, makes having this unique charitable organization as part of the family capital transfer strategy very attractive.

Creation of a private family foundation is generally accomplished by choosing one of two formats - a trust or a nonprofit corporation. In a trust, the terms of the foundation grant making policy and investment policy are defined. These definitions can be quite specific or very general. The trustees of such a trust have the responsibility of fulfilling the terms of the trust.

In an effort to maintain control over the activities of the foundation, there may be a tendency to create restrictions that are so narrow that the ability to accomplish the desired objectives may be difficult or even impossible at some time in the future. For example, if the purpose of trust distributions is to fight a specific disease, where are future grants made once that disease is cured? While trusts may be altered through the legal system and prudence in fulfillment of the trust intent can be relied upon to an extent, trusts do impose rigid requirements on the trustees compared to the corporate form of foundation organization. The ability to impose rigid requirements can be very important to many current owners of capital who are concerned about the future decisions that will be made regarding its use but should be well thought out before implementation. Without exception, however, a trust offers its creator (the trustor) the opportunity to protect the activities that their capital will be used to support.

State fiduciary statutes govern the management of trusts. Such statutes generally hold the trustees to a much higher standard of performance than their corporate director counterparts. While many states have provided for limited liability on the part of corporate nonprofit directors, such immunity from personal liability is generally not afforded to trustees of a charitable trust.

Trust documents or governing state statutes should allow trustees the ability to delegate investment responsibility. The terms of this delegation should allow for diversification of the portfolio under the concept of modern portfolio theory. This concept has been adopted for the guidance of the investment management of corporate nonprofit organizations by most states, and sets the stage for financial training of the rising generations.

The trust will clearly describe the process of replacing the named trustees. This provision for family foundations is critical for succession planning. The trust may require a mix of family and non-family members in its leadership. Certain states allow various formats of governance of the trust in terms of investment and distribution decisions. Consideration of each of these provisions should be explored before establishing where the trust is domiciled.

Organizing a private foundation as a nonprofit corporation is generally the most common and desirable format. The corporate structure provides for the adoption of articles of incorporation and bylaws, which form the basis for governing the organization. They define the board of directors and officers of the corporation as well as establish the procedure by which they are appointed or elected.

The board of the corporate foundation has the ability to amend the process by which it governs the affairs of the organization. It can determine the mission of the organization and change that mission in the future. Clearly, the corporate format provides greater flexibility for future generations. On the other hand, the founder may or may not have his or her original objectives fulfilled as the foundation matures in time and governance.

A private foundation, whether organized as a nonprofit corporation or a trust, offers the opportunity for the family to have successor control of the social capital permanently set aside by the current owner. This capital base cannot be used for the economic benefit of the contributing owner or members of the family. Penalties may be assessed if various activities within the foundation are allowed to occur. Annual reporting to the IRS is required. Capital placed in a private foundation may be managed and controlled by the family, but has irrevocably been set aside for the benefit of the public and is so regulated.

Gifts to a private foundation at death receive the same full estate tax deduction as if made to a public charity. However, transfers of capital during the life of the owner are restricted as to tax benefits. For example, when transferring appreciated assets, only publicly traded common stock can be deducted at the full fair market value on the date of the transfer. All other appreciated capital gifts are limited in deduction to their cost basis.

In addition, gifts of cash to a private foundation may be deducted in any given tax year up to only 30% of a taxpayer's adjusted gross income. Deductibility of gifts of appreciated publicly traded common stock at full fair market value is limited to 20% of the donor's adjusted gross income in any one tax year.

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